Statutes—Continued. Page
Revenue Act of 1917, c. 63, 40 Stat. 300, 302, 303, 305, 334, 335—
Secs. 200, 201, 206 27–28
Sec. 1207 11
Revenue Act of 1918, c. 18, 40 Stat. 1057, 1058, 1064, 1065, 1077—
Sec. 200 ..... 18, 28
Sec. 212 (b) 18, 29
Sec. 213 ..... 18, 29
Sec. 233 29
Sec. 234 29–30
Treasury Department Regulations and Decisions:
Regulations 31—
Arts. 2, 4, 6 ..... 16, 31–33
Regulations 33—
Art. 104 ..... 16, 33–34
Art. 148 ..... 16, 34
Art. 156 ..... 16, 34
Art. 158 ..... 16, 34–35
Regulations 33 (revised)—
Art. 126 35–36
Art. 127 36
Art. 128 36–37
Art. 180 37–38
Regulations 45—
Art. 23 8
Regulations 62—
Art. 23 8
Regulations 65—
Art. 23 8
Regulations 69—
Art. 23 8
Regulations 74—
Art. 322 8
Treasury Decision 2367 ..... 18, 38
Treasury Decision 2433 ..... 8, 20, 38–41
Reports of congressional committees:
House Report No. 922, 64th Cong., 1st sess., p. 4 ..... 7, 18, 42
House Report No. 1037, 65th Cong., 3d sess., pp. 3, 44 ..... 18, 42–43
Miscellaneous:
Cumulative Bulletin No. 4, January-June, 1921, p. 147 20

In the Supreme Court of the United States

OCTOBER TERM, 1930

No. 7

THE ALUMINUM CASTINGS COMPANY, PETITIONER,

v.

CARL F. ROUTZAHN, INDIVIDUALLY AND AS COLLECTOR of Internal Revenue

ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT ON REARGUMENT

OPINIONS BELOW

The opinion of the District Court for the Northern District of Ohio (R. 9–15) is reported in 24 F. (2d) 230. The opinion of the Circuit Court of Appeals (R. 151–155) is reported in 31 F. (2d) 669.

JURISDICTION

The judgment of the Circuit Court of Appeals (R. 151) was entered on April 2, 1929. The petition for certiorari was filed June 26, 1929 (R. 156), and was granted by this Court on October 21, 1929 (R. 155). The jurisdiction of this Court rests on

Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the Commissioner of Internal Revenue was correct in refusing to allow the munitions manufacturers' tax of the petitioner for the year 1916 as a deduction from gross income for the year 1917, when the tax was paid.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the appendices, *infra,* pp. 25–41.

STATEMENT

During 1916 and 1917 the petitioner was engaged in the manufacture of aluminum, brass, and bronze castings, including munitions of war. The profits from the sale of such articles were subject to the munitions tax under Title III of the Revenue Act of 1916, c. 463, 39 Stat. 756, 780. (R. 24.) During the year 1916 the petitioner realized substantial profits upon the sales of these articles and the munitions tax for 1916 amounted to the sum of $246,275.63, which tax was paid by the petitioner in 1917. (R. 24.)

The petitioner deducted the amount so paid from its gross income for the year 1917 in determining the amount of net income subject to income and excess profits taxes in that year. (R. 24.) The petitioner stated on the tax return which it filed for 1917 that it was filed upon the cash receipts and

disbursements basis, except that "Bills and accounts payable and receivable are treated as receipts and disbursements." (R. 31, 34, 98.) The petitioner's return for 1916 had been filed on the same basis, "bills and accounts payable and receivable being entered as cash" (R. 35), although it was stated in the return filed for that year that the cash basis was used (R. 81). Upon a reaudit of the returns filed for the years 1916 and 1917, the Commissioner of Internal Revenue disallowed the deduction of the munitions tax in the sum of $246,275.63 from the gross income of the petitioner for the year 1917, transferred it to the year 1916, and allowed it as a deduction from gross income for that year. (R. 24, 29.) This adjustment resulted in an additional tax in the net sum of $175,053.29. (R. 25, 30.) The collector collected part of this, and the rest of the asserted liability was discharged by application of a credit. (R. 25.) Petitioner sued the collector to recover the amount paid him.

The case was tried before the District Court on written waiver of jury trial. (R. 7.) The District Court found as facts that the petitioner's books of account for the years 1916 and 1917 were kept on an accrual basis (R. 25–26), and that its income-tax returns for these years were made on the accrual basis (R. 25–26). It accordingly held that the munitions tax on profits earned in 1916 was deductible from gross income in that year and not from gross income for 1917. (R. 23.) Judgment for the respondent (R. 26) was affirmed by the Cir-

cuit Court of Appeals for the Sixth Circuit (R. 151).

SUMMARY OF ARGUMENT

I

If the petitioner's tax return for the year 1917 was made substantially upon the accrual basis, the munitions tax for the year 1916 can not be deducted in computing taxable income for 1917. There are two methods of accounting which can reflect income clearly—the "cash receipts and disbursements" method and the "accrual" method. This fact was understood by Congress at the time the Revenue Act of 1916 was passed.

In order that income be clearly reflected, when a return is made on the accrual basis all items, both of receipts and disbursements, must be consistently included when accrued, whether paid or received or not. This plain economic fact has been asserted by the administrative regulations of the Treasury Department, the validity of which has been recognized in the decisions of this Court.

If any item in the return was incorrectly entered and should not have been included in a return made on the accrual basis, the Commissioner was justified in correcting the return as to that item.

II

The petitioner's return for the year 1917 was substantially upon the accrual basis. This was found as a fact by the District Court, and the Circuit Court of Appeals agreed that this was correct.

The evidence clearly establishes this. The testimony shows that for the years 1916 and 1917 the petitioner had accrued on its books bills receivable, accounts receivable, bills payable, accounts payable, accrued taxes other than accrued munitions taxes, items of sales invoiced to purchasers before the money was received, reserves for losses on doubtful accounts, and various other reserves.

The petitioner contends that its returns for 1916 and 1917 were on a "statutory" cash basis, such as had been required under the 1913 Act. But the Revenue Act of 1916 differed from the earlier Revenue Acts so materially that the previous regulations were not applicable. And in any event the previous regulations were not continued in effect. The petitioner's argument on this point is substantially the same as that which was rejected by this Court in *United States* v. *Anderson,* 269 U. S. 422.

It is immaterial that the petitioner's return stated that it was made upon the cash receipts and disbursements basis. The evidence shows that the return was in fact made substantially upon the accrual basis, and this fact should be controlling.

III

Even if the petitioner was entitled to change its return to one on a strictly cash basis, it has not shown what its tax liability would be on such a return, and hence it can not recover.

ARGUMENT

I

IF THE PETITIONER'S RETURN FOR 1917 WAS MADE SUBSTANTIALLY UPON THE ACCRUAL BASIS, THE MUNITIONS TAX FOR THE YEAR 1916 CAN NOT BE DEDUCTED IN COMPUTING TAXABLE INCOME FOR 1917

The Revenue Act of 1916, c. 463, 39 Stat. 756, 771, was the first of the various income tax acts to recognize the fact that taxable income may be computed on more than one basis.[1] Section 13 (d) of that Act provided that—

> A corporation, joint-stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned; * * *.

The petitioner's position in this case seems to be based upon the contention that under the Revenue Act of 1916 a corporation may properly make a

[1] The earlier acts, in providing for the computation of income and of deductions, used such words as "received" and "paid." See sec. 38 of the Corporation Excise Tax Law of 1909, c. 6, 36 Stat. 11, 112–113 (*infra*, p. 25), and subdivision G (a) of the corporation income tax provisions of the Act of October 3, 1913, c. 16, 38 Stat. 114, 172–173 (*infra*, pp. 25–266).

return of income upon a hybrid basis, which is not based consistently upon either accruals or cash receipts and disbursements. We contend that this position is untenable.

Experience has shown that there are two bases of accounts which can reflect income properly, namely, the "cash receipts and disbursements" basis and the "accrual" basis. That this fact was understood by Congress at the time Section 13 (d) was enacted is shown by the report of the Committee on Ways and Means to the House (House Report No. 922, 64th Congress, 1st Sess., p. 4; *infra*, p. 42), respecting the enactment of the section, which stated:

> As two systems of bookkeeping are in use in the United States, one based on the cash or receipt basis and the other on the accrual basis, it was deemed advisable to provide in the proposed measure that an individual or corporation may make return of income on either the cash or accrued basis, if the basis selected clearly reflects the income.

In order that income may be clearly reflected, it is necessary where income is computed on the accrual basis that all items, both of receipts and disbursements, must be consistently included when accrued, whether paid or received or not. This plain economic fact has been asserted in the administrative regulations of the Treasury Department, the validity of which has been recognized in the decisions of this Court.

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On January 8, 1917, shortly after the enactment of the Revenue Act of 1916, and before the petitioner in this case made its return for the year 1916, the Treasury Department promulgated Treasury Decision 2433 (*infra,* pp. 38–41), which provided:

> This ruling contemplates that income and authorized deductions shall be computed and accounted for on the same basis. * * *

In Article 23 of Regulations 45, promulgated under the Revenue Act of 1918, this requirement is stated as follows:

> A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency.

This regulation has been continued in force until the present without change. See Regulations 62 (1922 ed.), Article 23; Regulations 65 (1924), Article 23; Regulations 69 (1926), Article 23; Regulations 74 (1929), Article 322.

This Court has recognized the fact that if a return is on the accrual basis all items, both of receipts and disbursements, must be included as they accrue, if the return is to reflect income clearly. Thus, in *United States* v. *Anderson,* 269 U. S. 422, this Court said as to the purpose of Sections 12 (a) and 13 (d) of the Act of 1916 (p. 440):

> It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging

> against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis.
>
> The appellee's true income for the year 1916 could not have been determined without deducting from its gross income for the year the total cost and expenses attributable to the production of that income during the year. * * *

A similar statement is found in *United States* v. *Mitchell*, 271 U. S. 9, where it is said of the 1918 Act (pp. 12–13):

> Notwithstanding the option given taxpayers, it is the purpose of the Act to require returns that clearly reflect taxable income. That purpose will not be accomplished unless income received and deductible disbursements made are treated consistently. * * * It is a reasonable construction of the law that the same method be applied to both sides of the account.

Accordingly, it is our contention that if the petitioner's return for the year 1917 was made substantially on the accrual basis the munitions tax for the year 1916 must be treated on that basis, and can not be deducted when computing taxable income for the year 1917, in which it was in fact paid. It is, of course, beyond dispute that the

munitions taxes for the year 1916, the tax involved in this case, accrued in 1916. That question was expressly decided in *United States* v. *Anderson,* 269 U. S. 422.

If any item in the return was incorrectly entered and should not have been included in a return made upon the accrual basis, the Commissioner was justified in correcting the return as to that item. In its petition for certiorari the petitioner contended that the correction made by the Commissioner *ipso facto* required him to compute the entire tax on the cash receipts and disbursements basis. But this contention has since been disposed of by this Court in *United States* v. *American Can Co.,* 280 U. S. 412, 419, in which it was held that the correction of a single item in a return did not "constitute rejection of the basis upon which the return was constructed." A correction similar to the one involved in this case was sustained by this Court in *United States* v. *Anderson,* 269 U. S. 422. The *American Can case* and the *Anderson case* involved returns of taxes for the year 1917 and arose under the same Act as that here involved, the Revenue Act of 1916. In *Niles Bement Pond Co.* v. *United States,* 281 U. S. 357, 360, this Court said:

> Under the 1916 Act where the taxpayer's books are kept and his returns made on the accrual basis, taxes charged on the books as they accrue must be deducted when accrued, if true income is thus reflected. *United States* v. *Anderson,* 269 U. S. 422. *Even if*

> *not so charged,* it was competent for the Commissioner, under the Act of 1916, as well as under the express provisions of § 212 (b) of the Act of 1918, to correct the taxpayer's return by deducting the payments in the year in which they accrued so as to reflect true income by *conforming to the dominating or controlling character of the taxpayer's system of accounts.* (Italics ours.)

Petitioner argues that the action of the Commissioner unjustly operated to deprive it of the right to deduct Federal income taxes which accrued during 1916 but were not paid until 1917.[2] But the petitioner has not sought to have the correction made in its 1916 return. It would seem that if it had made timely application it would have been entitled to have these taxes deducted from its 1916 income. As this Court said of a similar situation in *Niles Bement Pond Co.* v. *United States,* 281 U. S. 357, 362, *supra:*

> If that assumption is made, failure of the Commissioner to correct the returns in these respects is as attributable to his error or oversight or lack of information as to any opinion on his part as to the propriety of the deductions in the years made.

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[2] Under the fourth paragraph of Section 12 (a) of the Revenue Act of 1916 "taxes paid within the year imposed by the authority of the United States" were deductible from gross income. Under Section 13 (b) of the 1916 Act the word "paid" would doubtless be read "paid or accrued." But by Section 1207 of the Act of October 3, 1917, c. 63, 40 Stat. 300, 334–335, this provision was amended so as to exclude the deduction of income and excess-profits taxes.

II

THE PETITIONER'S RETURN FOR THE YEAR 1917 WAS SUBSTANTIALLY UPON THE ACCRUAL BASIS

The District Court found as a fact that during the years 1916 and 1917 the petitioner (R. 25)—

> kept its accounts upon a basis other than that of actual receipts and disbursements, commonly known as an accrual basis.

It also found that the petitioner's tax returns for those years (R. 25–26)—

> were made, returned and filed on the basis on which its accounts were kept as aforesaid, viz., an accrual basis.

These conclusions were upheld by the Circuit Court of Appeals. (R. 155.) We do not rely wholly upon these findings. Apart from any effect which they may have as findings, we contend that the evidence clearly establishes that the findings were correct.

The testimony of the petitioner's witness Watson, who made out the petitioner's tax returns (R. 31), showed that for the years 1916 and 1917 the petitioner had accrued on its books bills receivable, accounts receivable, bills payable, accounts payable (R. 31, 35, 36), accrued taxes (R. 32, 36) other than accrued munitions taxes (R. 32),[3] items of sales

[3]Apparently the reason why the petitioner did not accrue munitions taxes on its books for the year 1916 was that it did not at the time regard itself as liable for these taxes. (Petitioner's Brief, pp. 34–35; R. 37.) The suggestion that these taxes did not accrue in 1916 because at the time liability for them was doubtful or contested is, we submit, without merit.

invoiced to purchasers before the money was received (R. 34), reserves for losses on doubtful accounts (R. 36), unpaid labor comprising both unpaid and unclaimed wages (R. 36), and reserves set up to take care of future possible expenditures and present unliquidated liabilities, such as reserves for commissions, for liability insurance, for fire insurance, for legal expenses, for high-priced metal, for Federal income taxes, for open receiving slips, and for unadjusted claims (R. 36).

The petitioner's witness Basler, an accountant who was in complete charge of its books of account during the years 1916 and 1917, and who assisted in the preparation of its tax returns for those years, testified that there were accrued on petitioner's books accounts payable, accounts receivable (R. 39–40), reserves for depreciation (R. 41), and prepaid expenses (R. 41).

Respondent's witness Dewey, a certified public accountant, who, while an Internal Revenue Agent, examined petitioner's books of account for the years in question, testified that petitioner's books were kept on the accrual basis, because it used accounts receivable and payable and accrued various items on its books as representing a liability that had not yet been paid in cash but were to be paid in the future, having been incurred but not paid; that he applied that rule to the bills and accounts payable as well as to items of insurance and taxes; that on

the cash basis accounts receivable and payable are not taken into consideration, but only the money actually received; that is, if a sale is made but the money is not then received, no entries are made on the books until the money is received (R. 42); and that his examination convinced him that the books were kept on the accrual basis (R. 45).

Respondent's witness, Cohen, a certified public accountant and Internal Revenue Agent, testified that he examined petitioner's books for the years 1916 and 1917 for the purpose of determining on which basis of accounting they were kept; that his "conclusion was that they were kept on the accrual basis"; that he "examined the income-tax returns and excess-profits tax returns for the years 1916 and 1917, filed by this Company" and "they appeared to be filed on the accrual basis"; that his conclusion was based on the facts that petitioner accrued on its books items of expense and carried deferred charges as assets; that its tax returns appeared to be filed on the accrual basis because they took into consideration accounts receivable and accounts payable as cash items; that petitioner's balance sheets contained items indicative of the accrual system of keeping books, such as prepaid expenses, accounts receivable, reserves for doubtful accounts, notes receivable, accounts payable, unpaid labor, and reserves for accrued liabilities such as reserves for commissions, accrued taxes, and legal expenses. (R. 46–47.)

In the light of the facts as established by this evidence we submit that the "dominating or controlling character of the taxpayer's system of accounts" and of its return was that of the accrual basis.[4] See *Niles Bement Pond Co.* v. *United States,* 281 U. S. 357, 360 (pp. 10–11, *supra*).

The petitioner contends that its return of income for 1916 was not made on the accrual basis but on the "statutory" cash receipts and disbursements basis, as prescribed by previous regulations. In examining this contention it will be necessary to discuss briefly the legislation and regulations which preceded the Revenue Act of 1916.

The Corporation Excise Tax Law of 1909, c. 6, 36 Stat. 11, 112–113 (*infra,* p. 25), and the corporation income tax provisions of the Act of October 3, 1913, c. 16, 38 Stat. 114, 172–173 (*infra*, pp. 25–26), made no express provision for returns upon

[4] The petitioner's gross income for 1917 was $18,696,446.73, of which $18,679,704.16 represented gross income from operations. The total deductions amounted to $17,283,304.91, of which $15,358,391.84 represented cost of goods and other property sold. (R. 87.) The item "Cost of Goods and Other Property Sold" was principally made up of $11,203,593.35, "Merchandise bought for sale." (R. 93.) Thus, the cost of raw materials and the sales price of the manufactured goods constituted the major items on petitioner's accounts. The cost of the raw material was entered on the books as Accounts Payable and the sales were entered on the books as Accounts Receivable. (R. 31, 34, 35.) These were accrual items, and not cash items: and it is apparent that the dominating and controlling character of petitioner's system of accounts was the accrual basis.

the accrual basis,[5] but the regulations issued under these Acts allowed many variations from a strict cash method of accounting. Articles 2, 4, and 6 of Regulations 31 (*infra,* pp. 31–33), promulgated under the Act of 1909, contained several provisions inconsistent with a strict cash basis in making returns. In Regulations 33, promulgated under the Act of October 3, 1913, Article 104 (*infra,* pp. 33–34), provided for the use of inventories, and Article 158 (*infra,* pp. 34–35) provided that—

> It is immaterial whether the deductions except for taxes and losses are evidenced by actual disbursements in cash, * * *.

But by Article 156 (*infra,* p. 34) of these regulations it was provided that taxes should be deducted only when actually paid, since that was the language of the Act allowing such deductions.[6]

The legislation of 1909 and 1913 and the regulations adopted under it showed that the subject was

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[5] But both Section 38 of the 1909 Act and Section G(b) of the 1913 Act allowed the deduction of depreciation, and the latter section allowed a deduction for depletion, items which would probably not be deductible in a strict cash receipts and disbursements system. This is simply another example of the formative stage of the law on this question at this period.

[6] As indicative of the formative stage of the practice at this period it should be noted that the Regulations under the 1909 and 1913 Acts made no sharp distinction between items "accrued" and items "received" or "paid," in the sense in which we now understand these terms. Thus, in Article 148 of Regulations 33 (*infra,* p. 34) it was provided that "The amount of interest *accrued and paid* within the year * * * constitutes an allowable deduction." (Italics ours.)

undeveloped, and that the resulting system was a mongrel one. The first explicit statutory recognition of the fact that the computation of income might depend upon the method of accounting used occurred in the Revenue Act of 1916, evidenced by the insertion of the new Section 13 (d), set out above (*supra*, p. 6).

The petitioner argues that the return filed was a proper return on the basis of cash receipts and disbursements under the 1909 and 1913 Acts, and that this return would have been a proper return under Section 12 (a) of the 1916 Act if Section 13 (d) had not been included in that Act. With this we have no dispute.[7] But the petitioner further contends that Section 13 (d) merely gave the taxpayer an option to file a return on another basis—an option which the taxpayer did not exercise—and that it had no effect upon the basis for making returns under Section 12 (a) if the taxpayer chose to continue to render returns on what had been a proper basis up to the time of the 1916 Act. But we submit that Section 13 (d) did not give the taxpayer an option to file a return on the mongrel basis which had been permitted under the regulations promulgated under earlier Acts.

Section 13 (d) was a stage in the introduction of approved accounting methods into the income

[7] The regulations, as construed in practice, treated accounts and bills receivable of a manufacturing corporation as income for the year in which they were created and allowed deductions of accounts payable when the liability was incurred. (R. 133.)

tax laws. The insertion of this section evidenced the recognition of Congress that the methods formerly required were not scientific, and did not clearly reflect income. See House Report No. 922, 64th Congress, 1st Session, p. 4; *supra,* p. 7.[8] We contend that after Congress had through Section 13 (d) given to taxpayers the option of filing a return on the accrual basis, no return could thereafter be filed as a cash return which was not in fact a cash return. After Section 13 (d) was enacted, the criterion by which a return was to be judged was whether it clearly reflected income, and we submit that a return in which accounts receivable are accrued, but taxes incurred in producing the receivables are not accrued, is not a return which clearly reflects income.

It is true that on September 14, 1916, shortly after the passage of the Revenue Act of 1916, the Commissioner of Internal Revenue issued Treasury Decision 2367 (*infra,* p. 38), which provided as follows:

> Pending the adoption and promulgation of special regulations under the act of September 8, 1916, income-tax regulations in force September 8, 1916, are hereby extended and made applicable to the act of September 8, 1916, so far as not inconsistent with the provisions of that statute.

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[8] The question was further clarified in the Revenue Act of 1918, c. 18, 40 Stat. 1057. See Sections 200, 212, and 213 of that Act, set out *infra,* pp. 28–29. See also House Report No. 1037, 65th Cong., 3d Sess., pp. 3, 44; *infra,* pp. 42–43.

Because of this ruling the petitioner contends that it was permitted to file its return for 1916 on the same basis which had been required under the 1913 Act. The flaw in this argument is the assumption that the kind of return which had been required under the 1913 Act, and the regulations promulgated thereunder, was in fact a return on the basis of cash receipts and disbursements. The mere fact that the petitioner made its returns for 1916 and 1917 on the same basis as its return for 1915 (R. 34) does not establish that its returns for 1916 and 1917 were made on the basis of cash receipts and disbursements.

In the first place the regulations in question were issued under an act which made no provision for returns on the accrual basis, while the Revenue Act of 1916, in Section 13 (d) (*supra,* p. 6), did contain such a provision. As this introduced a substantial change in the revenue laws, we submit that the provisions of the Revenue Act of 1916 were "inconsistent" with those of the 1913 Act, so that Treasury Decision 2367, *supra,* does not even in terms apply.

But in any event the Commissioner of Internal Revenue made specific provision for the situation now in question by a regulation issued under the Revenue Act of 1916, before the petitioner made its return for 1916 and more than a year before it made its return for the year in question. On January 8, 1917, the Treasury Department promul-

gated Treasury Decision 2433 [9] (*infra,* pp. 38–41), in which it was provided:

> This ruling contemplates that *the income and authorized deductions shall be computed and accounted for on the same basis* and that the same practice shall be consistently followed year after year. (Italics ours.)

The argument of the petitioner in this case seems to be essentially the same as that which was rejected by this Court in *United States* v. *Anderson,* 269 U. S. 422, where this Court said (pp. 438–439, 440):

> It was pressed upon us in argument by appellees that it was found impracticable to comply strictly with the requirements of the 1909 and 1913 Acts for computing income on the basis of receipts and disbursements and that under both acts the administrative practice was established, by appropriate Treasury regulations, permitting the use of inventories and authorizing deduction of expenses constituting a liability of the taxpayer, whether paid or not, in ascertaining net income, but that those regulations did not permit the deduction of taxes except in the year when paid. From this it is argued that Congress, by reenacting in § 12 (a) of

[9] This decision is discussed and followed in a long opinion of the Solicitor of Internal Revenue which appears in Cumulative Bulletin No. 4, January-June, 1921, p. 147. This opinion is referred to in *Niles Bement Pond Co.* v. *United States*, 281 U. S. 357, 359, and is copied in the Government's brief (pp. 47–60) in *United States* v. *Anderson,* No. 337, October Term, 1925.

the Act of 1916 the corresponding provisions of the earlier acts, adopted the settled administrative practice, and that accordingly under that act, as well as under the earlier acts and Treasury regulations, taxes could be deducted only in the year when paid.

This argument would have force had Congress stopped with the enactment of § 12(a). By thus adopting, without material change, the corresponding provisions of earlier acts, Congress might have been deemed to have recognized and adopted the established practice of the Department interpreting and applying them. *National Lead Co.* v. *United States,* 252 U. S. 140. But, in the Act of 1916, Congress added § 13(d), which did not have its counterpart in earlier legislation. This section went further than any previous regulation by authorizing the tax return to be made on the basis on which the taxpayer's books were kept, provided only that the basis was one reflecting income and the return complied with regulations made by the Commissioner.

* * * * *

The appellee's true income for the year 1916 could not have been determined without deducting from its gross income for the year the total cost and expenses attributable to the production of that income during the year. The reserve for munitions taxes set up on its books for 1916 must have been deducted from receivables for munitions sold in that year before the net results of the operations for the year could be ascertained.

> The taxpayer being unable to make its return on a strict receipts and disbursements basis, and not having attempted to do so, could not have complied with § 13(d) and Treasury Decision 2433 by deducting either accruals of interest or expenses alone without the other, or without deducting other reserves made on its books to meet liabilities such as the munitions tax, incurred in the process of creating income.

The petitioner argues that in making its return for 1916 it complied with the express provisions of the instructions on the blank furnished by the Treasury Department, which stated that only those taxes which had actually been paid during the year might be deducted. (R. 80.) But the form of this return was issued under the date of October, 1916, (R. 67) before Treasury Decision 2433, *supra,* was promulgated. It could hardly be contended that the Commissioner was precluded from changing his regulations, because at the time there was extant a form which contained provisions inconsistent with the new regulation. And the instruction as to the deduction of taxes on the form furnished to the petitioner for returning its 1917 income, now in question, correctly provided for the deduction of taxes "paid or accrued," evidently according to the taxpayer's method of accounting. (R. 97–98.) Moreover, nothing in the instructions on the returns for either 1916 or 1917 indicated that in a return made on the cash basis, accounts receivable

and payable should be treated as receipts and disbursements. (See R. 67–98.)

The petitioner contends that it designated its return as made upon the cash receipts and disbursements basis. Even if the petitioner had so stated on the return, that fact would not be controlling. But, in fact, the petitioner, in answer to the question whether its return for 1917 was made on the basis of actual receipts and disbursements, stated, "Yes; except as below indicated"; and further down on the return it explained this answer by saying, "Bills and Accounts Payable & Receivable are treated as receipts and disbursements." (R. 98.) We contend that a return in which bills and accounts payable and receivable are treated as receipts and disbursements is not a return on the cash receipts and disbursements basis, and that the inclusion of these items in the return makes it a return substantially upon the accrual basis. It is clear from the evidence outlined above (*supra,* p. 14) that the return was not in fact made upon a strict cash basis.

III

EVEN IF PETITIONER WAS ENTITLED TO CHANGE ITS RETURN TO ONE ON A STRICTLY CASH BASIS, IT HAS NOT SHOWN WHAT ITS TAX LIABILITY WOULD BE ON SUCH A RETURN, AND HENCE IT CAN NOT RECOVER

The taxpayer has never attempted to file a return strictly upon the cash receipts and disbursements basis, and it has not shown what its tax liability would be on that basis. The petitioner may have

had large cash receipts in 1917 which did not appear as income in its return for that year because it reported its gross income on the basis of accounts receivable. Consequently, even if the Commissioner was not justified in treating the munitions tax for 1916 as he did, the taxpayer has not shown that its tax liability would have been any less if its return had been computed on a strictly cash basis. Because of this circumstance we contend that even if the taxpayer was entitled to have its income computed on the cash basis, it can not succeed, as it has not sustained the burden of showing that the tax collected was in excess of what could legally have been exacted. The burden of establishing all facts essential to the recovery is on the petitioner. *Botany Mills* v. *United States,* 278 U. S. 282; *Reinecke* v. *Spaulding,* 280 U. S. 227.

CONCLUSION

It is respectfully submitted that the judgment of the Circuit Court of Appeals should be affirmed.

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OCTOBER, 1930.

APPENDIX A

STATUTES

The Corporation Excise Tax Law of 1909, c. 6, 36 Stat. 11, 112–113, provided:

> SEC. 38. That every corporation * * * shall be subject to pay annually a special excise tax * * * equivalent to 1 per centum upon the entire net income over and above five thousand dollars received by it from all sources * * *.
>
> Second. Such net income shall be ascertained by deducting from the gross amount of the income of such corporation * * * received within the year from all sources, (first) all the ordinary and necessary expenses actually paid within the year * * *; (second) all losses actually sustained within the year, * * * including a reasonable allowance for depreciation of property, if any, * * *; (third) interest actually paid within the year * * *; (fourth) all sums paid by it within the year for taxes * * *.

The corporation income-tax provisions contained in Subdivision G of Section 2 of the Act of October 3, 1913, c. 16, 38 Stat. 114, 172–173, provided:

> G. (a) That the normal tax hereinbefore imposed upon individuals likewise shall be levied, assessed, and paid annually upon the entire net income arising or accruing from all sources during the preceding calendar year to every corporation * * *.

(b) Such net income shall be ascertained by deducting from the gross amount of the income of such corporation * * * received within the year from all sources, (first) all the ordinary and necessary expenses paid within the year * * *; (second) all losses actually sustained within the year * * *, including a reasonable allowance for depreciation by use, wear and tear of property, if any; and in the case of mines a reasonable allowance for depletion of ores and all other natural deposits, * * *; (third) the amount of interest accrued and paid within the year on its indebtedness * * *; (fourth) all sums paid by it within the year for taxes * * *.

The Revenue Act of 1916 (Act of September 8, 1916), c. 463, 39 Stat. 756, 767–771, provided:

TITLE I.—INCOME TAX

* * * * *

PART II.—ON CORPORATIONS

SEC. 10. That there shall be levied, assessed, collected, and paid annually upon the total net income received in the preceding calendar year from all sources by every corporation, joint-stock company or association, or insurance company, organized in the United States, no matter how created or organized but not including partnerships, a tax of two per centum upon such income; * * *.

The foregoing tax rate shall apply to the total net income received by every taxable corporation, joint-stock company or association, or insurance company in the calendar year nineteen hundred and sixteen and in each year thereafter * * *.

* * * * *

SEC. 12. (a) In the case of a corporation * * * such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—

First. All the ordinary and necessary expenses paid within the year * * *;

Second. All losses actually sustained and charged off within the year * * *;

Third. The amount of interest paid within the year * * *;

Fourth. Taxes paid within the year * * *.

* * * * *

SEC. 13. * * *.

(d) A corporation * * * keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned;

The Revenue Act of 1917 (Act of October 3, 1917), c. 63, 40 Stat. 300, 302, 303, 305, contained the following provisions:

TITLE II.—WAR EXCESS PROFITS TAX

SEC. 200. That when used in this title—

* * * * *

The term "taxable year" means the twelve months ending December thirty-first, excepting in the case of a corporation or partnership which has fixed its own fiscal year, in which case it means such fiscal year. The first taxable year shall be the year ending December thirty-first, nineteen hundred and seventeen, except that in the case of a

corporation or partnership which has fixed its own fiscal year, it shall be the fiscal year ending during the calendar year nineteen hundred and seventeen. * * *

* * * * *

SEC. 201. That in addition to the taxes under existing law and under this act there shall be levied, assessed, collected, and paid for each taxable year upon the income of every corporation, partnership, or individual, a tax (hereinafter in this title referred to as the tax) equal to the following percentages of the net income:

* * * * *

SEC. 206. That for the purposes of this title the net income of a corporation shall be ascertained and returned * * * (c) for the taxable year upon the same basis and in the same manner as provided in Title I of the Act entitled "An Act to increase the revenue, and for other purposes," approved September eighth, nineteen hundred and sixteen, as amended by this Act, except that the amounts received by it as dividends upon the stock or from the net earnings of other corporations, joint-stock companies or associations, or insurance companies, subject to the tax imposed by Title I of such Act of September eighth, nineteen hundred and sixteen, shall be deducted.

The Revenue Act of 1918, c. 18, 40 Stat. 1057, 1058, contained the following provisions:

SEC. 200. That when used in this title—

* * * * *

The term "paid," for the purposes of the deductions and credits under this title, means "paid or accrued" or "paid or incurred," and the terms "paid or incurred" and "paid or accrued" shall be construed

according to the method of accounting upon the basis of which the net income is computed under section 212.

SEC. 212. * * *.

(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. * * *

SEC. 213. That for the purposes of this title * * * the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, * * * or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; * * *.

SEC. 233. (a) That in the case of a corporation * * * the term "gross income" means the gross income as defined in section 213, * * *.

SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year * * *;

(2) All interest paid or accrued within the taxable year * * *;

(3) Taxes paid or accrued within the taxable year * * *;

APPENDIX B

TREASURY REGULATIONS AND DECISIONS

REGULATIONS

Regulations 31, promulgated December 3, 1909, under the Act of August 5, 1909, provided:

ARTICLE 2. *Gross Income.*—The following definitions and rules are given for determining the gross income of the various classes of corporations:

* * * * *

3. *Manufacturing companies.*—Gross income received during the year from all sources will consist of the total amount, ascertained through an accounting, that shows the difference between the price received for the goods as sold and the cost of such goods as manufactured. The cost of goods manufactured shall be ascertained by an addition of a charge to the account of the cost of goods as manufactured during the year of the sum of the inventory at beginning of the year and a credit to the account of the sum of the inventory at the end of the year. To this amount should be added all items of income received during the year from other sources, including dividends received on stock of other corporations, joint-stock companies, associations, and insurance companies subject to this tax. In the determination of the cost of goods manufactured and sold as above such cost shall comprehend all charges for

maintenance and operation of manufacturing plant, but shall not embrace allowances for depreciation of property nor for losses sustained which are to be taken account of in ascertaining the net income subject to tax under the proper heading in the authorized deductions.

* * * * *

It will be noted from these definitions that gross income is practically the same as gross profits, the only difference being that gross income is more inclusive, embracing as it does not only gross profits of the corporation, joint-stock company and association itself, but also all amounts of income received from other sources. It is immaterial whether any item of gross income is evidenced by cash receipts during the year or in such other manner as to entitle it to proper entry on the books of the corporation from January 1 to December 31 for the year in which return is made.

* * * * *

ARTICLE 4. *Deductions.*—The specified deductions actually paid within the year, set forth in the statute and as described in article 3 preceding, shall include all proper items of expenses and charges under the respective heads as designated. The amount returned for ordinary and necessary expenses actually paid within the year out of income in maintenance and operation of the business and properties of the corporation should not, however, embrace allowances for depreciation of fixed property which are otherwise to be taken account of under the proper heading in the authorized deductions, nor expenses paid within the year and charged to such allowances for depreciation credited in the current year or in previous

years. In ascertaining expenses proper to be included in the deductions to be made under this article, corporations carrying materials and supplies on hand for use should include in such expenses the charges for materials and supplies only to the amount that the same are actually disbursed and used in operation and maintenance during the year for which the return is made.

It is immaterial whether the deductions are evidenced by actual disbursements in cash, or whether evidenced in such other way as to be properly acknowledged by the corporate officers and so entered on the books as to constitute a liability against the assets of the corporation, joint-stock company association, or insurance company making the return.

* * * * *

ARTICLE 6. * * *

Bookkeeping.—No particular system of bookkeeping or accounting will be required by the Department. However, the business transacted by corporations, joint-stock companies, associations, or insurance companies must be so recorded that each and every item therein set forth may be readily verified by an examination of the books and accounts, where such examination is deemed necessary.

Regulations 33, promulgated January 5, 1914, under the Act of October 3, 1913, provided:

ART. 104. Gross income of manufacturing companies shall consist of the total sales of manufactured goods during the year covered by the return, increased or decreased by the gain or loss as shown by the inventories of finished and unfinished products, raw material, etc., at the beginning and end of the year. To this amount should be added the

income, gains, or profits from all other sources as shown by the books of account.

ART. 148. The amount of interest accrued and paid within the year by a corporation on an amount of bonded or other indebtedness not in excess of *one-half* of the *sum* of the interest-bearing indebtedness *and* the paid-up capital stock outstanding at the close of the year, or, if no capital stock, on the amount of interest-bearing indebtedness not exceeding the amount of capital employed in the business at the close of the year, constitutes an allowable deduction; that is, the maximum principal, upon which interest for the purpose of this deduction, can be computed must not exceed, in the one case, one-half of the sum of the interest-bearing indebtedness and the capital stock outstanding at the close of the year, or, in the other case, must not exceed the amount of capital employed in the business at the close of the year. The interest to be deductible must have been computed on the proper principal at the contract rate and must have been actually paid within the year.

ART. 156. Reserves for taxes can not be allowed, as the law specifically provides that only such sums as are paid within the year for taxes shall be deducted.

ART. 158. It is immaterial whether the deductions except for taxes and losses are evidenced by actual disbursements in cash, or whether evidenced in such other way as to be properly acknowledged by the corporate officers and so entered on the books of the corporation as to constitute a liability against the assets of the corporation making the return. Deductions for taxes, however, should be the aggregate of the amounts actually paid, as shown on the cash book of

the corporation. Deductions for losses should be confined to losses actually sustained and charged off during the year and not compensated by insurance or otherwise. Except as the same may be modified by the provisions of the act, limiting certain deductions and authorizing others, the net income as returned for the purpose of the tax should be the same as that shown by the books or the annual balance sheet.

Regulations 33 (revised), promulgated January 2, 1918, under the provisions of the Revenue Act of 1916, as amended by the Act of October 3, 1917, provided:

> ART. 126. *"Paid" or "actually paid."*— "Paid" or "actually paid," within the meaning of this title, does not necessarily contemplate that there shall be an actual disbursement in cash or its equivalent. If the amount involved represents an actual expense or element of cost in the production of the income of the year, it will be properly deductible even though not actually disbursed in cash, provided it is so entered upon the books of the company as to constitute a liability against its assets, and provided further that the income is also returned upon an accrued basis.
>
> If in the course of its business, a corporation credits the accounts of individuals, firms, or corporations with the amount of any expenses, interest, rentals, wages, etc., due them, thereby making them subject to the personal drawings of such creditors, or if expenses actually incurred are vouchered in definite amounts, the amounts so credited or vouchered may be treated as paid, and if the amounts so credited or vouchered are expenses incurred concurrently with and in

the production of the income of the year, they may be allowably deducted therefrom.

* * * * *

ART. 127. *Approved accounting practices.*—Pursuant to the foregoing provision, corporations keeping their accounts in strict accord with the methods prescribed by municipal, State, or Federal authorities, or in accord with approved standard accounting practices consistently followed from year to year, will be permitted to make their returns of annual net income on the basis of the accounts so kept, provided such systems of accounting clearly and correctly reflect the net income of each year.

Charges against current earnings.—All expenses, including interest, taxes, and other necessary charges, incidental and necessary to the creation or production of the gross income or properly chargeable against the same, being deductible from the gross income, whether paid in cash or entered on the books as a liability, can not, if unpaid, be carried forward to be deducted from the gross income of a subsequent year.

Each year's return complete.—Each year's return, both as to income and deductions therefrom, must be complete within itself. Charges, of whatever character, against income can not be cumulative. They must be deducted from the income of the year in which incurred or not at all. The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year.

* * * * *

ART. 128. *Previous year's charges not deductible.*—A corporation having the right under this rule to deduct all authorized

allowances, whether paid in cash or set up as a liability, it follows that if it does not within any year pay or accrue certain of its expenses, interest, taxes, or other charges, and makes no deduction therefor, it can not deduct from the income of the next or any subsequent year any amounts then paid in liquidation of the previous year's liabilities.

Amended returns.—If, however, a corporation discovers or detects expenses or liabilities which were due and payable during a preceding year, it will be permissible for it to make an amended return for the year to which such expense or liability applies, include such expense in the deductions of that year, and file a claim for refund for any taxes overpaid by reason of the failure to deduct such expense or liability in the original return of that year.

Any system of accounting which is not consistent with the purpose and intent of the rules set out in this title, and with the general rules set out in these regulations for the ascertainment of net income, will not be accepted as a correct basis for making returns.

* * * * *

ART. 180. * * *

Paid or charged as a liability.—The amount of interest thus computed at the contract rate, if actually paid within the year, may be deducted, or if the accounts of the company are kept on a basis other than actual receipts and disbursements, the amount of interest actually accrued at the contract rate, if computed on an amount not in excess of the maximum principal as hereinbefore indicated, may be deducted, provided it is so entered upon the books as to constitute a liability against the assets, and provided it does not include interest on in-

debtedness incurred in the purchase of securities, the income from which is not subject to the income tax.

TREASURY DECISION 2367

Treasury Department,
Office of Commissioner
of Internal Revenue,
Washington, D. C., September 14, 1916.

To collectors of internal revenue:

Pending the adoption and promulgation of special regulations under the act of September 8, 1916, income-tax regulations in force September 8, 1916, are hereby extended and made applicable to the act of September 8, 1916, so far as not inconsistent with the provisions of that statute.

W. H. OSBORN,
Commissioner of Internal Revenue.

Approved:

BYRON R. NEWTON,
Acting Secretary of the Treasury.

TREASURY DECISION 2433

Treasury Department,
Office of Commissioner
of Internal Revenue,
Washington, D. C., January 8, 1917.

To collectors of internal revenue:

Subparagraph (d) of section 13 of Title I of the act of September 8, 1916, provides that—

> A corporation, joint-stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless

> such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury, make its returns upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned.

Under this provision it will be permissible for corporations which accrue on their books monthly or at other stated periods amounts sufficient to meet fixed annual or other charges to deduct from their gross income the amounts so accrued, provided such accruals approximate as nearly as possible the actual liabilities for which the accruals are made, and provided that in cases wherein deductions are made on the accrual basis as hereinbefore indicated income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax on the same basis.

In cases wherein, pursuant to the consistent practice of accounting of the corporation, or pursuant to the requirements of some Federal, State, or municipal supervising authority, corporations set up and maintain reserves to meet liabilities, the amount of which and the date of payment or maturity of which is not definitely determined or determinable at the time the liability is incurred, it will be permissible for the corporations to deduct from their gross income the amounts credited to such reserves each year, provided that the amounts deductible on account of the reserves shall approximate as nearly as can be determined the actual amounts which experience has demonstrated would be necessary to discharge the liabilities incurred

during the year and for the payment of which additions to the reserves were made; and provided, if it shall be found that the amount credited to any such reserve is in excess of the reasonable or probable needs of the corporation to meet and discharge the liabilities for which the reserve is credited, the excess of such reserve over and above the reasonable or probable needs for the purpose indicated shall be at once disallowed as a deduction and restored to income for the purpose of the tax; and provided further, that in no event will sinking funds or other reserves set up to meet additions, betterments, or other capital obligations constitute allowable deductions from gross income.

This ruling contemplates that the income and authorized deductions shall be computed and accounted for on the same basis and that the same practice shall be consistently followed year after year. Amounts paid in discharge of any liability or obligation for which a reserve has been set up, as hereinbefore outlined, will, when paid, be charged to the reserve created to meet it, in so far as such reserve is sufficient to meet the liability, provided always that the liability is of a character which constitutes an allowable deduction within the meaning of the law.

If upon investigation it shall be found that returns made upon the basis of accruals and reserves do not reflect the true net income, the corporation so failing in this way to return the true net income will not thereafter be permitted to make its returns upon any basis other than that of actual receipts and disbursements.

The reserves contemplated by the foregoing ruling are those reserves only which are set up to meet

some actual liability incurred, the amount necessary to discharge which can not at the time be definitely determined, and do not contemplate reserves to meet losses contingent upon shrinkage in values, losses from bad debts, capital investments, etc., which losses are deductible only when definitely determined as the result of a closed or completed transaction and are charged off.

W. H. OSBORN,
Commissioner of Internal Revenue.

Approved:

W. G. MCADOO,
Secretary of the Treasury.

APPENDIX C

Reports of Congressional Committees

REVENUE ACT OF 1916

Report of the Committee on Ways & Means to the House (House Report No. 922, 64th Congress, 1st Session, p. 4):

> The present law requires that the income tax shall be levied on the accrued basis. As two systems of bookkeeping are in use in the United States, one based on the cash or receipt basis and the other on the accrual basis, it was deemed advisable to provide in the proposed measure that an individual or corporation may make return of income on either the cash or accrued basis, if the basis selected clearly reflects the income.

REVENUE ACT OF 1918

Report of the Committee of Conference to the House (House Report No. 1037, 65th Congress, 3rd Session, pp. 3, 44):

> Amendment numbered 13: That the House recede from its disagreement to the amendment of the Senate numbered 13, and agree to the same with an amendment as follows:

In lieu of the matter inserted by said amendment insert the following:

> *The term "paid," for the purposes of the deductions and credits under this title,*

means "paid or accrued" or "paid or incurred," and the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212.

And the Senate agreed to the same.

* * * * * *

Amendment No. 13: This amendment provides that the terms "paid or incurred" and "paid or accrued" when used in the income-tax title shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212; and the House recedes with an amendment defining the word "paid" when used for the purpose of computing the deductions and credits.

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